



NAGDCA NOTES

Contribution of Sick and Vacation Pay to Defined Contribution Plans

Prepared by: NAGDCA Legislative Committee

There is no explicit statute, regulation, or practice that expressly forbids contribution of accrued sick or vacation pay to a defined contribution plan. The historic practice restricted contribution of these amounts to a 457 plan because tax regulations required that the election to contribute be made by the employee before the compensation was earned. Once sick or vacation pay had accrued, it was "earned" and it was too late to make a contribution election within the requirements of the original 457 regulations.

A convincing argument can be made that the recently adopted 457 regulations explicitly allow contribution of accrued sick and vacation pay to a 457 plan. The regulations state:

- (d) *Deferral of sick, vacation, and back pay under an eligible plan—(1) In general.* An eligible plan may provide that a participant may elect to defer accumulated sick pay, accumulated vacation pay, and back pay under an eligible plan if the requirements of section 457(b) are satisfied. For example, the plan must provide, in accordance with paragraph (b) of this section, that these amounts may be deferred for any calendar month only if an agreement providing for the deferral is entered into before the beginning of the month in which the amounts would otherwise be paid or made available and the participant is an employee in that month.

At the 2003 NAGDCA annual meeting there was much discussion about this item. The main focus concerned comments by IRS personnel. The comments were to the effect that accrued sick/vacation pay may only be contributed to a plan (either 457 or 401(k)) if the amounts are actually transferred to a plan trustee while the employee retains his employment status. Thus, examples were given that this type of pay cannot be contributed if the actual transfer to the trust occurs after an employee has left the premises, turned in his keys, and officially severed the employment relationship. In such a case, it was stated, a deficiency assessment against the employee in the amount of the contribution was possible. The essence of this theory is that it is a requirement of plan administration that contributions be made only by employees; and sick and vacation pay transferred to a trust after severance from employment is (under that standard) not a qualifying contribution. The NAGDCA legislative committee has reviewed this matter and offers the following comments on this administrative issue.

1. **Restricted Nature of Comments.** Neither NAGDCA, nor its employees or agents, nor members of its Legislative Committee, provide tax, financial, accounting or legal advice. This memorandum should not be construed as tax, financial, accounting or legal advice; it is provided solely for informational purposes. NAGDCA members, both government and industry, are urged to consult with their own attorneys and/or tax advisors about the issues addressed herein.
2. **General Rule.** Nothing in the code explicitly requires deferred salary (including sick and vacation pay) to be transferred to the plan prior to severance from employment. While the Internal Revenue Service could promulgate regulations

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imposing this type of detailed transfer requirement, neither 457 nor 401(k) regulations contain such a restriction. Instead, the Committee's reading of the regulations is that they adopt a contrary view, and do not require transfer to the trust prior to severance. See, e.g., Reg. §1.457-8(a)2(ii)("Amounts deferred . . . must be transferred to a trust within a period that is not longer than is reasonable for the proper administration of the participant accounts (if any)"); Erisa Reg. §2510.3-102. An additional problem with a pre-severance transfer requirement is that it could also apply to deferral from an employee's final pay check—which will be universally delivered to the trust after a severance from employment has occurred. See, e.g., Reg. §1.457-4(b)(deferral election remains in effect until revoked). The general practice—for 457, 401(k) and the federal thrift savings plan—allows plan contributions from the final pay check, even though the transfer occurs after severance. The legislative committee believes that there is no principle, statute, or regulation that requires a different result for deferral of accrued vacation pay.

Tax law does require that the deferral/contribution be made by an employee. See, e.g., §457(b)(1)("only individuals who perform service for the employer may be participants"); §457(c)(3)(participant defined as someone eligible to defer compensation under the plan). The NAGDCA legislative committee believes that this requirement is met if the election to defer occurs during employment status (e.g., pre-severance), and the contribution to the trust of the accrued sick or vacation pay occurs within a reasonable time after the election, whether or not a severance from employment has occurred.

Administrators should note that this does not allow deferral of all sick or vacation pay. For example, assume that a statute in state X provides that accrued sick and vacation pay is payable over a three-year period after severance from employment. Contribution of these amounts to a 457 plan might be subject to challenge (even if the election was made prior to severance from employment), because these amounts would never be paid to an employee. "Garden variety" sick or vacation pay is different; it will be paid in cash if the employee takes a vacation, gets sick, or terminates employment. It therefore should be subject to the same rules as the final paycheck: if paid within a reasonable time after termination it may be transferred to the plan or qualified trust at that time, even if the electing participant is no longer an employee.

3. **Application to 401(k) and 403(b) plans.** The examination of this issue was prompted by the recently promulgated §457 regulations. Administrators should note, however, that this issue applies to all plans that receive elective deferrals—including 401(k) and 403(b) plans—when the transfer to the trust occurs after termination of employment.

Conclusion. Plan administrators face a difficult decision on whether to allow contributions of accrued sick and vacation pay to 457 or 401(k) plans, in light of colloquial IRS insistence that all elements of the transaction (both election and contribution) must occur prior to severance. In theory, the IRS could assess a tax deficiency against a participant who made this type of contribution. As noted above, plan sponsors should consult with legal counsel and other professionals to determine the appropriate course of action for contribution of these amounts. The NAGDCA Legislative Committee will continue to monitor this issue, and press the IRS for explicit guidance on how to structure contributions of accrued vacation pay and similar compensation that is clearly defined as compensation for plan purposes, yet inherently is either paid or contributed after severance.